

NO. 77690-3

SUPREME COURT OF THE STATE OF WASHINGTON

U.S. SMOKELESS TOBACCO BRANDS INC.,
PREVIOUSLY KNOWN AS
UNITED STATES TOBACCO SALES AND
MARKETING COMPANY INC.,

Petitioner,

vs.

STATE OF WASHINGTON,
DEPARTMENT OF REVENUE,

Respondent.

PETITIONER'S SUPPLEMENTAL BRIEF

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TABLE OF CONTENTS

	Page
I. INTRODUCTION	1
II. ARGUMENT	2
A. Petitioner's Valuation Experts Presented Uncontroverted Evidence of Fair Market Value for Tobacco Manufacturing's Sales of OTP to <i>Any</i> Purchaser Who Performs the Functions that Tobacco Sales Performs.....	2
B. There Is No Unexplained Disparity in the Arm's Length Prices Indicated by the 1995 and 1992 Ernst & Young Transfer Price Studies.	10
C. There Is No Discrepancy in the Willamette Management Appraisal Regarding the Actual Transfer Price in 1992.....	11
D. Tobacco Sales Did Not Offer Confusing Evidence.	11
III. CONCLUSION.....	12
APPENDIX	
Appendix 1.....	Defendant's Cross Motion Under CR 56 for Summary Judgment

TABLE OF AUTHORITIES

Page

CASES

<i>Bausch & Lomb Inc. v. Comm'r</i> , 933 F.2d 1084 (1991).....	8
<i>U.S. Tobacco Sales & Mktg. Co. v. Dept. of Revenue</i> , 96 Wn. App. 932, 982 P.2d 652 (1999).....	1, 2, 10, 12
<i>U.S. Tobacco Sales and Marketing Co. Inc. v. Washington State Dept. of Revenue</i> , 128 Wn. App. 426, 115 P.3d 1080 (2005).....	passim
<i>Weyerhaeuser Co. v. Easter</i> , 126 Wn.2d 370, 894 P.2d 1290 (1995).....	10
<i>Xerox v. County of Orange</i> , 66 Cal. App. 3d 746, 136 Cal. Rptr. 583 (1977).....	6

STATUTES

RCW 82.26.010(7).....	3, 6
26 U.S.C. § 482.....	4, 5, 6, 7

OTHER AUTHORITIES

26 C.F.R. § 1.482-1(a)(1)	5
26 C.F.R. § 1.482-1(b)(1).....	4
26 C.F.R. § 1.482-3(b)(2)(ii)(B)(3)	5, 6
26 C.F.R. § 1.482-3(c)(2)(i).....	2
USPAP Rule 7-3(b) and Official Comment.....	6

I. INTRODUCTION

The Petitioner, U.S. Smokeless Tobacco Brands Inc. ("Tobacco Sales") appeals only limited portions of the last two paragraphs of the Court of Appeals' decision below.¹ In those two paragraphs, the Court of Appeals made three legal errors which led it to order an unnecessary and inappropriate remand:

1. The court incorrectly suggested that Petitioner's valuation experts allowed the affiliation between Tobacco Sales and Tobacco Manufacturing to taint their calculation of the fair market value of OTP sold by Tobacco Manufacturing to Tobacco Sales.

2. The court misunderstood the relationship between the 1995 Ernst & Young transfer price study introduced by the Department of Revenue in *U.S. Tobacco I* and the 1992 Ernst & Young transfer price study introduced by Tobacco Sales at trial.

3. The court mistakenly believed that the Willamette Management appraisal was unclear regarding whether the actual transfer price in 1992 was 62.5¢ per can or 73¢ per can.

Correcting these three errors eliminates any reason to remand for

¹ The decision below is reported as *U.S. Tobacco Sales and Marketing Co. Inc. v. Washington State Dept. of Revenue*, 128 Wn. App. 426, 115 P.3d 1080 (2005) ("*U.S. Tobacco II*"). The first appeal in this case is reported as *U.S. Tobacco Sales & Mktg. Co. v. Dept. of Revenue*, 96 Wn. App. 932, 982 P.2d 652 (1999) ("*U.S. Tobacco I*").

further trial court proceedings.²

II. ARGUMENT

A. Petitioner's Valuation Experts Presented Uncontroverted Evidence of Fair Market Value for Tobacco Manufacturing's Sales of OTP to Any Purchaser Who Performs the Functions that Tobacco Sales Performs.

The central issue in this appeal is whether the Court of Appeals erred in ordering another remand where the Petitioner presented unimpeached and uncontroverted evidence of the fair market value of the OTP that it purchased in 1992 from its manufacturing affiliate. The decision in *U.S. Tobacco II* reiterates the court's conclusion in *U.S. Tobacco I* that the Department's value – based on Tobacco Sale's resale price of \$1.43 per can – is not the correct measure of the OTP tax. *U.S. Tobacco II*, 128 Wn. App. at 434. This is because the OTP tax is measured by the manufacturer's selling price and Tobacco Sales is not the

² There is one additional correction to the Court of Appeals' opinion that should be noted, although it did not directly affect the outcome. The court mistakenly characterized the Department's \$1.43 price per can as a valuation determined by the "resale price method." *U.S. Tobacco II*, 128 Wn. App. at 433. The Department, however, did not use the resale price method to reach its \$1.43 value. "The resale price method measures an arm's length price *by subtracting the appropriate gross profit from the applicable resale price* for the property involved in the controlled transaction under review." Treas. Reg. §1.482-3(c)(2)(i) (emphasis added). The Department did not subtract *anything* from the resale price. Instead, its valuation assumed that Tobacco Sales would purchase the OTP for \$1.43 per can and resell it for the same \$1.43 price, thus guaranteeing a substantial loss on every can sold. Valid appraisal analysis cannot assume such irrational behavior by the taxpayer.

manufacturer.³ Moreover, Tobacco Sales' resale price cannot reflect the *manufacturer's* selling price because "Tobacco Sales increased the value of the OTP [that it purchased from the manufacturer] through an array of activities, including sales, marketing, promotions, product sampling, and distribution." *U.S. Tobacco II*, 128 Wn. App. at 433-434. These facts are indisputable.

The taxpayer's valuation experts presented clear and uncontroverted evidence that the market value of the OTP sold by Tobacco Manufacturing was 68¢ to 72¢ per can. The Department's appraiser did not dispute that this was the correct fair market value for a sale by a manufacturer to a distributor. RP 361. *See also U.S. Tobacco II*, 128 Wn. App. at 437. While the Court of Appeals again rejected the Department's valuation theory, it nevertheless ordered yet another remand, stating that it was "not convinced" that the 68¢ to 72¢ per can range "truly reflects the fair market value." *Id.* The stated basis for this unease was the court's fear that the taxpayer's experts might have allowed the affiliation between Tobacco Manufacturing and Tobacco Sales to taint their valuation analysis. This concern, however, is groundless.

The experts did not improperly consider the affiliation between

³ The statutory tax measure is "the established price for which a *manufacturer* sells a tobacco product to a distributor . . ." RCW 82.26.010(7) (emphasis added). Tobacco Manufacturing is the manufacturer and Tobacco Sales is the distributor. *U.S. Tobacco II*, 128 Wn. App. at 430.

Tobacco Manufacturing and Tobacco Sales. To the contrary, their analysis expressly removed affiliation as a factor in determining the fair market value of the OTP purchased by Petitioner. They applied the arm's length valuation methodologies of Treas. Reg. § 1.482 which, as the court acknowledged, are "specifically designed to determine the 'arm's-length' price of intercompany transfers." *U.S. Tobacco II*, 128 Wn. App. at 433 n.3. An arm's length price must be "consistent with the results that would have been realized if uncontrolled [*i.e.* unaffiliated] taxpayers had engaged in the same transaction under the same circumstances." Treas. Reg. §1.482-1(b)(1). In other words, an arm's length price under I.R.C. § 482 cannot reflect affiliation. It must, instead, reflect the price that would be charged in a transaction between unaffiliated entities. Given that there is no dispute that the taxpayer's experts properly applied the § 482 valuation methodologies, there can be no claim that they somehow allowed affiliation to skew their conclusions.

The Court of Appeals suggested that the experts' trade level analysis was the source of the affiliation problem, on the theory that "the qualifier 'level of trade' included the affiliation between Tobacco Manufacturing and Tobacco Sales."⁴ This suggestion, however, is directly

⁴ The court provided the following explanation of its affiliation concern:

at odds with the evidence, with generally accepted appraisal principles and with the specific requirements for arm's length valuations under § 482. In fact, trade level and affiliation are independent concepts which must be separately evaluated in appraisal analysis.⁵ Trade level concerns the point in the manufacturing/distribution chain at which value is measured, irrespective of affiliation. The Uniform Standards of Professional

But certain language from those [valuation] studies and the testimony from which they were presented suggest that the qualifier "level of trade" included the affiliation between Tobacco Manufacturing and Tobacco Sales. As such, the court's market price would not reflect the price of OTP sold between unaffiliated entities.

U.S. Tobacco II, 128 Wn. App. at 437. In footnote 8 accompanying this text, the court identified the testimony giving rise to the affiliation concern:

Q. Let's take my hypothetical though, Mr. Reilly. Isn't it true that – let's say Wal-Mart came in and said we're going – for all our stores have our own internal unit, we don't care about you nationally, [Tobacco] Manufacturing, but we're going to push your products in our stores and we're a big customer. Isn't it true that if [Tobacco] Manufacturing did sell to them that they would charge them a higher price than what they charge to [Tobacco Sales]?

A. Well, would they, I just don't think it would ever be possible because that's just not a hypothetical that I could see occurring on the planet Earth, given the economics, the principles of economics that have, you know, been around since Malthus and Ricardo and for the last several hundred years.”

Id. Mr. Reilly's befuddlement regarding the hypothetical posed by Mr. Hankins is discussed *infra* at note 9.

⁵ The I.R.C. § 482 arm's length price standard is specifically designed to remove potential affiliate influence on an intercompany price between affiliated entities. *See, e.g.*, Treas. Reg. § 1.482-1(a)(1) (“Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer. . .”). These regulations separately require that the arm's length price reflect market value at the trade level at which the controlled transaction occurs. *See, e.g.*, Treas. Reg. § 1.482-3(b)(2)(ii)(B)(3).

Appraisal Practice (“USPAP”) require that in every appraisal of personal property the appraiser must identify the correct valuation point (or “trade level”).⁶ USPAP Rule 7-3(b) and Official Comment. Similarly, the I.R.C. § 482 regulations require that an arm’s length price reflect value at the correct level of trade. Treas. Reg. § 1.482-3(b)(2)(ii)(B)(3) (requiring adjustment of comparable uncontrolled transactions to reflect the correct level of trade). Here, the proper trade level is the manufacturer’s selling price because the OTP tax is measured by “the established price for which a *manufacturer* sells a tobacco product to a distributor”

RCW 82.26.010(7) (emphasis added). Mr. Reilly and Mr. Lotfi determined an arm’s length, fair market value price for just such a sale, *i.e.*, one in which the manufacturer and distributor are “independent entities dealing at arm’s-length rather than corporate affiliates subject to common ownership.” Pl. Ex. 1, at 2-3, CP 297-98. *See also* RP 168-69, 187-88. This undisputed evidence established the fair market value of the OTP at the correct trade level: it provides a market value price for the transactions that actually occurred.⁷

⁶ The value of personalty changes as it moves through the distribution chain. Values typically increase as goods move from the manufacturer to the consumer. Pl. Ex. 1 at 4-6; RP 160-61. *See also Xerox v. County of Orange*, 66 Cal. App. 3d 746, 754, 136 Cal. Rptr. 583 (1977).

⁷ It is worth reiterating that the Department’s appraiser accepted Mr. Reilly’s appraisal as a correct measure of fair market value at this trade level. *U.S. Tobacco II*, 128 Wn. App. at 431-32. It is also important to bear in mind the

Affiliation is not a factor in identifying the level of trade at which value is appraised. Both the fair market value standard and the equivalent arm's length standard under § 482 require appraisers to measure value at the correct level of trade and to measure value by the price for a transaction between unaffiliated entities.⁸ The taxpayer's experts strictly and correctly adhered to these standards. The Court of Appeals' suggestion that this adherence was somehow improper is incorrect.

The Court of Appeals directed the parties on remand to present evidence of "the price a *completely unaffiliated entity* would have had to pay to purchase OTP from Tobacco Manufacturing in 1992." *U.S. Tobacco Sales II*, 128 Wn. App. at 437-38 (emphasis in original). This instruction is perplexing because Mr. Reilly and Mr. Lotfi have already presented undisputed evidence of the arm's length price to a completely unaffiliated purchaser. That evidence reflects the value of the OTP at the correct level of trade. Petitioner is at a loss to understand why that evidence was not sufficient or what different evidence it is supposed to

amici curiae concern that rejecting the widely accepted valuation principles and methodologies applied by the taxpayer's experts would open the door to arbitrary and wasteful differences among the states in tax administration standards. See Amicus Memorandum of Association of Washington Business at 6-7, Amicus Memorandum of COST and NAM at 3-5, and Amicus Memorandum of Institute of Professionals in Taxation at 4-8.

⁸ The Court of Appeals and all of the valuation experts for both parties recognized that the federal arm's length standard is equivalent to fair market value. See *U.S. Tobacco II*, 128 Wn App. at 433 n. 3; RP 52, 183-84, 356.

provide on remand.

The Court of Appeals seems to have been concerned because Tobacco Manufacturing itself does not sell directly to other third party distributors, such as Wal-Mart. *See supra* note 4. That concern reflects a fundamental misunderstanding of appraisal principles and the market value standard. The appraiser's task is to measure fair market value for the transactions that actually occurred, not to value other transactions with different terms and conditions. The relevant inquiry is the market price at which the OTP would exchange "between independent economic entities conducting the identical transactions at arm's length." *Bausch & Lomb Inc. v. Comm'r*, 933 F.2d 1084, 1089 (1991) (emphasis added). The price which might have induced Tobacco Manufacturing to change its business model and sell directly to other distributors (such as Wal-Mart) is irrelevant to the fair market value for the transaction that actually took place between Tobacco Manufacturing and Tobacco Sales. The Court of Appeals was in error if it thought that fair market value is the price that would have induced Tobacco Manufacturing to abandon its exclusive marketing relationship in favor of non-exclusive selling arrangements with multiple distributors.

Tobacco Manufacturing does not sell directly to multiple domestic distributors because it achieves higher profits selling through a single

distributor who manages the brand promotion, marketing, sales and distribution functions so as to maximize brand value. As pointed out by the taxpayer's expert, it would be economically irrational for Tobacco Manufacturing to abandon its successful business model in favor of a strategy that would undermine the value of its own brands.⁹

The relevant valuation question is whether Tobacco Manufacturing's actual price for its sales to Tobacco Sales in 1992 was discounted as compared to the fair market value of those sales. This is precisely the question that was answered by the taxpayer's experts. Mr. Reilly and Mr. Lotfi correctly measured the arm's length market price at which a manufacturer, standing in the shoes of Tobacco Manufacturing, would sell to a completely unaffiliated distributor who performed the same functions as Tobacco Sales, under the same terms and economic conditions. This arm's length price does not reflect the affiliation between Tobacco Sales and Tobacco Manufacturing. To the contrary, it provides exactly the evidence called for by the Court of Appeals in *U.S. Tobacco I*: a market value price for the taxpayer's purchases of OTP.

⁹ When the Department's counsel, Mr. Hankins, asked Mr. Reilly whether Tobacco Manufacturing would charge a higher price if it were to sell directly to Wal-Mart, Mr. Reilly was understandably incredulous. Mr. Reilly understood that Tobacco Manufacturing would never sell directly to multiple distributors. His appraisal is based on a transaction in which the unaffiliated buyer and seller would continue the exclusive sales and marketing arrangement that exists between Tobacco Manufacturing and Tobacco Sales. See RP 168-69, 185-191.

The Department of Revenue presented no valuation evidence of its own and nothing to contest or impeach the clear evidence submitted by the taxpayer's experts. Therefore, the taxpayer's evidence should be conclusive, and its valuation should be substituted for the Department's erroneous \$1.43 assessment. *Weyerhaeuser Co. v. Easter*, 126 Wn.2d 370, 381, 894 P.2d 1290 (1995).

B. There Is No Unexplained Disparity in the Arm's Length Prices Indicated by the 1995 and 1992 Ernst & Young Transfer Price Studies.

The Court of Appeals stated that there is an unexplained disparity between the price shown by the Ernst & Young study in *U.S. Tobacco I* and the price shown by the Ernst & Young study introduced at trial. *U.S. Tobacco II*, 128 Wn. App. at 437. There is no such disparity. The study introduced by the Department in *U.S. Tobacco I* was for 1995. It was based on 1995 sales and cost information.¹⁰ The study introduced at trial by Tobacco Sales was for 1992, based on 1992 sales and cost data. *See* Pl. Ex. 1. The differences between these studies simply reflect the fact that the arm's length price in 1992 was different than the arm's length price

¹⁰ The Department has continued to claim that Tobacco Sales placed the Ernst & Young study into the record in *U.S. Tobacco I* and that it was a study for 1992 rather than 1995. *See* Department's Answer to Petition for Review at 4. The true facts, however, are indisputable. The study introduced in *U.S. Tobacco I* was for 1995, not 1992. CP 747-978 (see especially Ex. 19 and Ex. 20, CP 887 and 888). And it was the Department, not Petitioner, who placed that study into the record. CP 740-41 (Department's Cross Motion for Summary Judgment ¶ 7(e), copy attached as Appendix 1).

in 1995. This is not an unexplained disparity or contradiction, it is simply two separate sets of facts relating to two different time periods. This is not a reason for another remand.

C. **There Is No Discrepancy in the Willamette Management Appraisal Regarding the Actual Transfer Price in 1992.**

The Court of Appeals also states that the Willamette Management appraisal contains a discrepancy regarding whether the invoice price in 1992 was 62.5¢ or 73¢ per can. *U.S. Tobacco II*, 128 Wn. App. at 437 n. 9. This is nothing more than a misunderstanding of the evidence. It is a stipulated fact that the actual 1992 price was 62.5¢ per can. CP 134 (FF No. 19). That price was set early in 1992 based on projected sales and cost data for 1992. The 73¢ price referenced at p. 23 of the Willamette Management appraisal is what the transfer price *would have been* had it been calculated with end-of-year historical sales and cost data for 1992 rather than the projected data that were actually used. This was fully explained by Mr. Reilly at trial (*see* RP 145-50) and thoroughly discussed in Tobacco Sales' Petition for Review at 14-15. There is no need for a remand to clarify these facts.

D. **Tobacco Sales Did Not Offer Confusing Evidence.**

Finally, the Department asserts that "the Court of Appeals perhaps rejected Tobacco Sales' evidence because Tobacco Sales offered three different prices to measure the OTP tax It is no wonder the Court of

Appeals remanded the matter to the trial court for further proceedings.”

Answer to Petition for Review at 16. These assertions misstate the evidence. Petitioner did not offer three different prices to measure the OTP tax. Instead, it produced evidence of the actual price charged in 1992 by Tobacco Manufacturing (62.5¢ per can) and evidence of the fair market value price for those sales (68¢ to 72¢ per can). This is not confusing evidence. It is exactly the evidence called for by *U.S. Tobacco I*.¹¹

III. CONCLUSION

The Petitioner met its burden of proof and is entitled to entry of judgment based on that proof. Its valuation experts presented uncontroverted and unimpeached evidence that the fair market value of the OTP in 1992 was between 68¢ and 72¢ per can. The Department presented no valuation evidence of its own and nothing to dispute or contradict Petitioner’s evidence. There are no substantive inconsistencies or discrepancies in the experts’ reports or testimony. There is no evidence that the experts are anything less than highly competent and credible experts. There is no basis for ordering yet another trial.

Petitioner respectfully requests that the Court reverse the Court of Appeals’ remand order and set the fair market value price at 72¢ per can

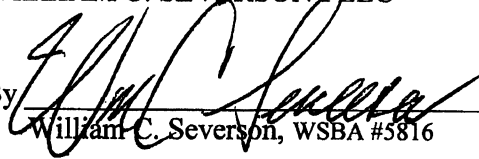
¹¹ The remand instruction in *U.S. Tobacco I* stated that, “to determine whether Tobacco Manufacturing’s price is discounted, *the trier of fact must compare Tobacco Manufacturing’s price with the fair market value of its products.*” *U.S. Tobacco I*, 96 Wn. App. at 942 (emphasis added).

(the highest value shown by the evidence). If the Court believes that only the trial court can set that value, Petitioner asks that the matter be remanded solely for the limited purpose of setting value within the scope of the evidence, that is, between 68¢ to 72¢ per can.

DATED this 14th day of July, 2006.

WILLIAM C. SEVERSON PLLC

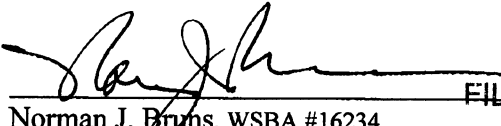
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APPENDIX 1

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IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
IN AND FOR THURSTON COUNTY

UNITED STATES TOBACCO SALES
AND MARKETING COMPANY INC.,

Plaintiff,

v.

STATE OF WASHINGTON,
DEPARTMENT OF REVENUE, et al.,

Defendants.

NO. 97-2-00883-0

DEFENDANT'S CROSS MOTION
UNDER CR 56 FOR SUMMARY
JUDGMENT

The Defendant State of Washington, Department of Revenue moves this Court, pursuant to CR 56 for Summary Judgment of dismissal of Plaintiff's complaint. There exist no issues of material fact and the sole issue is one of law: what is the correct statutory measure of the Other Tobacco Products ("OTP") Tax.

This motion is based on the files and records in this matter including but not limited to the following:

1. Defendant's Memorandum in Support of Cross Motion for Summary Judgment and In Opposition to Plaintiff's Motion for Summary Judgment.
2. Affidavit of Steven D. Smith PhD.
3. Affidavit of Steve Frisch.
4. First and Second Affidavits of Gary O'Neil.
5. Affidavit of Leslie Cushman

DEFENDANT'S CROSS MOTION FOR
SUMMARY JUDGMENT

- 1

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1 6. Plaintiff's Responses to First, Second and Third Sets of Interrogatories.

2 7. The following documents provided by Plaintiff in response to
3 First, Second and Third Requests for Production:

	<u>Description</u>	<u>Document Number</u>
4 a)	Letter of February 8, 1990	P100124
5	from Gary Meno, USTC Tax	
6	Manager, to state taxing	
	authorities.	
7 b)	"Agreement" (re: title)	P100125-P100127
8 c)	Listing of UST Related	P100128-P100135
	Corporate Family Members	
9 d)	Computer printout	P100321-P100325
10 e)	Transfer Pricing Study	P100326-P100558
	by Ernst & Young.	
11 f)	UST Organization Charts	P100559-P100560
12 g)	Quarterly Checks from Sales	P100798-P100825
	to Manufacturing	
13 h)	Insurance Documentation	P100826-P100831
		P100874-P100875
14 i)	Example Bill of Lading	P100832-P100834
15 j)	Invoice Documentation	P100835-P100836
16 k)	"Terms and Conditions"	P100837

17 There exists no genuine issue of material fact and Defendant is entitled to a judgment
18 as a matter of law.

19 DATED this 25th day of August, 1997.

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CERTIFICATE OF SERVICE

The undersigned declares under penalty of perjury, under the laws of the State of Washington, that the following is true and correct:

That on the date below signed, I caused a true and correct copy of the Petitioner's Supplemental Brief and this Declaration of Service to be served on counsel listed below by electronic mail and U.S. First Class Mail at the addresses listed below:

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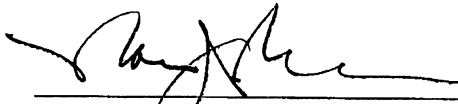
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